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**Draft EPSAS Screening Report
IPSAS 39 - Employee benefits**

*Paper by PwC in cooperation with Eurostat
- written consultation -*

This document was commissioned by Eurostat. It analyses the consistency of the named IPSAS standard with the draft EPSAS framework, with a view to informing future EPSAS standard setting. This version was prepared taking into account comments received from the participants of the Cell on Principles related to EPSAS Standards.

In advance of the autumn 2020 Working Group meeting, participants are invited to provide written comments on the analysis provided and on the conclusions reached.

Pilot EPSAS screening report

IPSAS 39 - Employee benefits

March 2020



Table of contents

Background	3
Screening of IPSAS 39 'Employee benefits' against criteria set in the draft EPSAS framework	6
Conformity with Qualitative Characteristics	6
Alignment with other frameworks	19
European Public Good	20
Conclusion	22

Background

Objectives

We refer to the general introduction to the pilot EPSAS screening reports that covers the following elements:

- Key objectives of EPSAS.
- Standard setting process in the public sector.
- Purpose and scope of the screening reports.
- Approach of the screening reports.
- European public good.
- Common elements considered when preparing the reports.

General introduction to IPSAS 39

IPSAS 39 is based on International Accounting Standard (IAS) IAS 19 ‘Employee benefits’, revised by the International Accounting Standards Board (IASB) in 2011. In developing IPSAS 39, the International Public Sector Accounting Standards Board (IPSASB) applied its ‘Process for Reviewing and Modifying IASB Documents’ that identifies public sector modifications where appropriate. This approach enables the IPSASB to build on best practices in private sector financial reporting, while ensuring that the unique features of the public sector are addressed.

The objective of the IPSAS 39 standard is to prescribe the accounting and disclosure for employee benefits. The standard requires an entity to recognise:

- (a) A liability when an employee has provided service in exchange for employee benefits to be paid in the future; and
- (b) An expense when the entity consumes the economic benefits or service potential arising from service provided by an employee in exchange for employee benefits.

The standard applies to all employee benefits, except share-based payment transactions. There are four categories of employee benefits, and a different accounting treatment applies to each of them:

- short-term benefits;
- post-employment benefits;
- other long-term benefits;
- termination benefits.

The first three categories relate to benefits that are granted in exchange of services rendered by the employee while the last one relates to benefits for which granting is triggered by the termination of employment.

Short-term benefits and other long-term benefits are due to be settled during employment (within 12 months from service rendered or later), while post-employment benefits are settled after the end of employment.

Employee benefits include benefits provided to either employees or their dependants (spouses, children or other dependants) and may be settled by payments (or the provision of goods or services) made either directly to them or through others, such as insurance companies.

Arrangements in respect of employee benefits may take various forms:

- formal plans or agreements between an entity and individual employees, groups of employees, or their representatives;
- legislative requirements, or industry arrangements, whereby entities are required to contribute to national, state, industry or other multi-employer plans or where entities are required to contribute to the composite social security program; or
- informal practices that give rise to a constructive obligation, leaving the entity with no realistic alternative but to pay employee benefits, for instance when a change in practices would cause unacceptable damage to the relationship with employees.

Scope of the report

As part of its strategy, the IPSASB maintains convergence between IPSAS and IFRS to the extent the public sector context does not warrant a specific accounting treatment. Between 2008 and 2011, the IASB made several revisions to IAS 19 that were addressed by the IPSASB in IPSAS 39.

A primary purpose of these revisions was to create more consistency in accounting for employee benefits by eliminating the recognition and presentation options that existed under IPSAS 25, which was the predecessor of IPSAS 39. Furthermore, the IPSASB sought to provide more targeted disclosure requirements that would highlight the relevant risks of defined benefit plans.

Reference to EFRAG assessment

EFRAg published its final endorsement advice on IAS 19 (as revised in 2011) in October 2011. EFRAG's overall assessment is that the overall benefits for preparers and users of IAS 19 (2011) are likely to outweigh one-off incremental costs and ongoing costs for preparers and users associated with understanding and implementation of IAS 19 (2011).

Reference to EPSAS issue papers¹

The PwC study of 2014² analysed the suitability of the IPSAS standards as a basis for developing EPSAS. This included the analysis of IPSAS 25 “Employee benefits”, subsequently replaced by IPSAS 39. Following this analysis, IPSAS 25 was classified among the category “Standards that (may) need (some) amendments or for which implementation guidance is (maybe) needed”.

Classification under this category does not mean that the standard should necessarily be changed, but that Member States should have another chance to discuss and evaluate the EPSAS accounting principles in the area of employee benefits.

The key question was to agree on the rules that determine whether a present obligation exists for the government at the balance sheet date in respect of pension and other benefits granted to employees, in which case a liability needs to be recognised in accordance with accrual accounting principles that are generally accepted on an international level. The debate is closely linked to the definition of a liability and includes consideration of concepts such as ‘sovereign power’, ‘legal versus constructive (or non-legal) obligation’ and ‘valid expectation’.

The study concluded that the “guidance might need to be developed to ensure consistency in how Member States interpret whether they have a present obligation or not, and how liabilities with respect to any such obligations should be measured”.

Otherwise, the study revealed no major conceptual issues with IPSAS 25 relating to the QC of information included in the GPFSSs.

During the course of developing the technical proposal on EPSAS, Eurostat commissioned a series of twenty technical issues papers (IPs), which analyse in particular key public sector specific accounting issues. The papers were discussed at the EPSAS Working Group meetings during 2016-2018. The papers are all publicly available on Eurostat’s website.

An EPSAS issue paper on the accounting treatment of employee benefits (pensions) discussed by the EPSAS WG on 9 November 2016.

Eurostat tentatively concluded the following in respect of the above paper:

- priority should be given in first instance to the comparability of the measurement and to the conceptual approach underpinning the choice of the discount rate.

¹ EPSAS Issues papers are available on <https://ec.europa.eu/eurostat/web/epsas/key-documents/technical-developments>

² Collection of information related to the potential impact, including costs, of implementing accrual accounting in the public sector and technical analysis of the suitability of individual IPSAS standards (Ref. 2013/S 107-182395)

Screening of IPSAS 39 ‘Employee benefits’ against criteria set in the draft EPSAS framework

Introduction

The EPSAS criteria listed in the draft EPSAS framework have been used to perform an assessment of IPSAS 39 ‘Employee benefits’, published in 2016 by the IPSASB.

In order to develop recommendations, one should first consider whether IPSAS 39 would meet the qualitative characteristics of the draft EPSAS CF, i.e. whether it would provide relevant, reliable, complete, prudent, neutral, verifiable, economically substantive, understandable, timely and comparable information and would not be contrary to the true and fair view principle.

This report considers recognition, classification and measurement as well as presentation and disclosure requirements applicable to provisions, contingent liabilities and contingent assets for each of the qualitative characteristics of the draft EPSAS CF.

Further, this paper includes a high-level comparison between the requirements of IPSAS 39 and other international accounting and financial reporting frameworks applied by the public sector entities in various jurisdictions, such as IFRS, ESA 2010 and EU Accounting Rules, bearing in mind the objective of alignment, reduction of cost of implementation and compliance cost.

Finally, this paper assesses whether IPSAS 39 would be conducive to the European public good.

The findings are presented below and the conclusion is included in the next section of this report.

Conformity with Qualitative Characteristics

Relevance

Based on the draft EPSAS CF, a liability should be recognised when a past obligating event has taken place (creating a legal or non-legal binding obligation which an entity has little or no realistic alternative to avoid), and the amount can be measured in a way that achieves the QC and takes account of constraints on information in GPFSSs .

With respect to post-employment benefits, this fundamental accounting principle is translated in the following manner:

- A past event creating a legal or non-legal binding obligation has taken place if and when the employee has rendered a **service**.
- The unit-of-account for post-employment benefits is the single plan, i.e. it is not acceptable to combine all post-employment benefit plans for the purposes of recognition and measurement.
- For defined benefit plans, granting a pension promise and the recognition of a pension liability is disconnected from the funding of pension promises.

In other words, the recognition and measurement of pension liabilities is not affected by the existence or non-existence of funding of these promises at the reporting date. For example, the existence of a “pay as you go” system, where current tax payments and/or current contributions to pension funds are used for the payments of current pensions, does not necessarily imply that a pension liability does not need to be recognised.

The recognition principles in the standard are consistent with the definition of a liability in the draft EPSAS CF, under the assumption that the employee service creates a binding legal or non-legal (constructive) obligation for an entity without any realistic alternative to avoid.

As a reminder, a liability is a **present obligation** of the entity for an **outflow of resources** that results from **past events or transactions**. A present obligation is a legally binding obligation (legal obligation) or non-legally binding obligation, which an entity has little or no realistic alternative to avoid.

- A legal obligation is enforceable in law.
- Non-legally binding obligations differ from legal obligations in that the party to whom the obligation exists cannot take legal (or equivalent) action to enforce settlement.

Short-term employee benefits

Accounting for short-term employee benefits is straightforward because no actuarial computation is required to measure the obligation and because the cost of the obligation is measured on an undiscounted basis. The entity recognises the short-term employee benefits cost when an employee has rendered services in exchange for these benefits, and a liability to the extent that the benefits are not yet paid at the reporting date.

Post-employment benefits

Post-employment benefits include pension plans, post-employment life insurance, medical plans, repatriation grants, etc. Post-employment benefit plans are classified as either defined contribution plans or defined benefit plans, depending on the economic substance of the plan as derived from its principal terms and conditions. The accounting treatment by the entity should reflect the risks it is bearing.

Defined contribution plans are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or

constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

Under defined contribution plans, the entity's legal or constructive obligation is limited to the amount that it agrees to contribute to the fund. Thus, the amount of the post-employment benefits is determined by the amount of contributions paid by an entity (and perhaps also the employee) to a post-employment benefit plan or to an insurance company, together with investment returns arising from the contributions. Consequently, the risk (actuarial risk and investment risk) falls on the employee, not on the entity.

Defined benefit plans are post-employment benefit plans other than defined contribution plans. Under defined benefit plans, the entity's obligation is to provide the agreed benefits to current and former employees. Consequently, the risk (actuarial risk and investment risk) falls, in substance, on the entity. If actuarial or investment performance is worse than expected, the entity's obligation may be increased.

Under IPSAS 39, an entity uses the projected unit credit method to determine the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost. The projected unit credit method (sometimes known as the accrued benefit method prorated on service or as the benefit/years of service method) sees each period of service as giving rise to an additional unit of benefit entitlement and measures each unit separately to build up the final obligation.

Defined benefit plans may be unfunded, or they may be wholly or partly funded by contributions paid by an entity, and sometimes its employees, into an entity or a fund that is legally separate from the reporting entity and from which the employee benefits are paid.

The items should be recognised as non-financial liabilities in financial statements only if they satisfy the definition of a liability in the draft EPSAS CF and the essential characteristic of a liability is that the entity has a present obligation arising from the past event. The requirements of IPSAS 39 are aligned with definition of an element (a liability) in the draft EPSAS CF.

Further, non-financial liabilities should meet recognition criteria defined in the draft EPSAS CF: (a) an item satisfies the definition of an element; and (b) can be measured in a way that achieves the qualitative characteristics and takes account of constraints on information in GPFSSs. The items which fail to meet the definition of an element and the recognition criteria cannot be recognised.

The amount to be recognised as a defined benefit liability (DBL) in the statement of financial position is basically the net total of the following amounts:

- the present value of the defined benefit obligation (DBO) at the reporting date;
minus

- the fair value at the reporting date of plan assets (if any) out of which the obligations are to be settled directly.

If the calculation gives a negative amount, the entity recognises a defined benefit asset (DBA). The amount of this asset should be limited to the net total of any cumulative unrecognised actuarial losses and past service cost plus the present value of any economic benefits available under the form of refunds from the plan or reductions in future contributions to the plan.

The information about post-employment benefits as required by IPSAS 39 is relevant in assessing the level of obligations and the timing of cash outflows. It has an important predictive value because it shows the level of cash outflows required to settle the obligations, arising from both legal and constructive obligations.

Other long-term benefits

According to IPSAS 39, liabilities must also be recognised for other long-term employee benefit obligations (such as long-term paid absences, jubilee or other long-service benefits and long-term disability benefits).

It should be noted that the measurement of other long-term employee benefits is not usually subject to the same degree of uncertainty as the measurement of post-employment benefits. For this reason, IPSAS 39 requires a simplified method of accounting for other long-term employee benefits. Unlike the accounting required for post-employment benefits, this method does not recognise remeasurements in net assets/equity. Otherwise, the same recognition and measurement principles apply as for post-employment benefits.

Disclosures

IPSAS 39 provide the users of financial statements with relevant information for defined benefit plans in the disclosure notes. An entity shall disclose description of the characteristics of the defined benefit plan (e.g. nature of the benefits provided, regulatory framework in which the plan operates, and entity's responsibilities for the governance of the plan) and additional quantitative and qualitative information about the amounts recognised in the financial statements.

IPSAS 39 para 148 requires the entity to *disclose a description of any asset-liability matching strategies used by the plan or the entity (...)*. Although an asset-liability strategy may be an example, it should be considered whether wider information regarding strategies for managing the plan and the risks should be disclosed, since it may be useful for the users of financial statements.

IPSAS 39 para 149 requires entities to provide with an indication of the effect of the defined benefit plan on the entity's future cash flows. Specifically, it requires the disclosure of any funding arrangements and funding policy that affect future contributions and the expected contributions to the plan for the next reporting period. However, users of the financial statements may need further information, such as, for example, evaluation of the long-term impact on the entity's future cash flows.

Currently, under IPSAS 39 para 147, entities have to (a) disclose a sensitivity analysis for each significant actuarial assumptions, showing how the defined benefit obligation would have been affected by changes in the relevant actuarial assumptions; (b) the methods and assumptions used in preparing the sensitivity analyses; and (c) changes from the previous period in the methods and assumptions used in preparing the sensitivity analyses, and the reasons for that changes.

These disclosures enhance a faithful representation of the economic phenomena. It should however be noted that, in the context of the post-implementation review of IAS 19, users of IFRS financial statements have expressed the view that providing further disclosures, including the effect of interrelationships between different assumptions and assumptions with non-linear effects, and comparing sensitivities across the different plans, may lead to the better reflection of the plans' risks.

Based on the assessment of recognition, measurement, presentation and disclosure requirements against the QC of relevance in the draft EPSAS framework, the standard would result in the provision of relevant information with an important predictive value, helpful for decision making. For example, the level of obligation indicates future cash outflows and is helpful in making funding decisions.

Objective evidence of constructive obligation may be difficult to assess when it comes to the existence of informal practices and stated internal policies. Description of the management judgment is necessary in such cases, for the information to be relevant and complete.

Actuarial assumptions are an entity's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits. The reliability of the assumptions used in the determination of the best estimate of the cash outflow could affect relevance and reliability of the information.

Faithful representation / Reliability

To be reliable, financial and non-financial information must provide a faithful representation of the substance of economic and other phenomena that it purports to represent.

The notion of faithful representation and reliability in the draft EPSAS CF is linked to the qualitative characteristics of completeness, prudence, neutrality, verifiability and substance over form. These are separately discussed below.

As stated above, under QC 'Relevance', the robustness of the assumptions used in the measurement of provisions could affect the reliability of the information.

Determining the amount of the defined benefit obligation implies the following:

- making a reliable (and best) estimate of the amount of benefit that employees have earned in return for the service they have rendered. This requires the entity to make (actuarial) assumptions about demographic variables (such as employee turnover and mortality) and financial variables (such as future

increases in salaries and medical costs) that will influence the cost of the benefit.

Actuarial assumptions should be unbiased and mutually compatible in order to provide reliable and useful information to the users. The financial assumptions should be based on market expectations, at the reporting date, for the period over which the obligations are to be settled.

- discount the defined benefit using the projected unit credit method in order to determine the present value of the defined benefit obligation and the current service cost. Under this methodology, each period of service is considered as giving right to an additional unit of benefit entitlement. In practice, for the most common benefit (pension plan), it means the extra amount of pension earned for each year of service. The plan formula indeed generally uses salary and service as variables.
- the DBO represents the entity's obligation at the reporting date, before considering any funding; it is based on current service but calculated on a projected salary at retirement; the service cost (SC) represents the cost of one extra year of service.

One assumption has an important impact on the value of the DBO: the discount rate. Under IPSAS 39, the discount rate should reflect the time value of money but not the actuarial or investment risk. The entity should exercise its judgment in assessing whether the time value of money is best approximated by reference to market yield on government bonds, corporate bonds or another financial instrument. The issue of consistency is further addressed under the QC "Comparability".

Based on the sound conceptual basis, consistent with the draft EPSAS framework, IPSAS 39 requires the recognition of the net defined benefit liability for DB plans in the statement of financial position. The net defined liability is arrived by deducting any plan assets from the defined benefit obligation (DBO). The standard does not include any exemptions from this accounting principle. All post-employment benefit schemes should be classified as either defined contribution or defined benefit plan. For the defined benefit plans, recognition of the net defined liability is required. The screening of IPSAS 39 does not raise any significant issues concerning reliability. Application of the recognition and measurement requirements for employee benefits results in a faithful representation of the non-financial obligations in the statement of financial position, consistent with the definition of a liability and the recognition criteria defined in the draft EPSAS CF. Principle-based accounting concepts have one important advantage: they are capable of providing reliable and understandable information on long-term employee benefit liabilities, for example post-employment benefit liabilities, despite significant diversity in the features of the pension schemes. The use of long-term assumptions and projecting the future cash flows might to some extent reduce the reliability and verifiability of the information. Nevertheless, disclosure of the assumptions and the sensitivity analysis required by IPSAS 39 contribute to the faithful representation of the risks associated with long-term employee benefit obligations.

Completeness

Recognition of pension and other long-term obligations in the statement of financial position by governments having defined benefit plans results in presenting complete information about the legally binding or non-legally binding obligations, which an entity has little or no realistic alternative to avoid.

To the extent that past services rendered by employees represent government obligations on the reporting date, liabilities should be recognised in relation to these past services. This reasoning is in accordance with the generally accepted accrual principles and definition of a liability in the draft CF framework. Recognising pension liabilities on the balance sheet (to the extent that a present obligation has been created for the government) provides useful information. It indicates the extent to which liabilities need to be funded either by future revenue³ or by raising debts. This information should help the decision-making about the adequate funding of the defined benefit plans. Moreover, consistently with the draft EPSAS CF, the existence of “sovereign power” should not be considered in determining whether a liability exists.

Under the requirements of IPSAS 39, the change in the net defined benefit liability (asset) is disaggregated into a service cost, a net interest and a remeasurements component. The distinction between service cost, net interest and remeasurements makes it possible to distinguish the effect of facts related to the performance by the employees (service cost) from the effects due to the passage of time and from changes in the components that represent the period-to-period fluctuations in the long-term value of the defined benefit obligation and plan assets.

Therefore, the disaggregation of components is consistent with the aggregation application principle and provides relevant and useful information to users.

The level of disaggregation is also reflected in the disclosures when requiring certain reconciliations to explain the amounts in an entity's financial statements arising from its defined benefit plans. Those disclosures also require additional information about the exposure to risk and information about the asset-liability matching strategies.

IPSAS 39 requires additional information about post-employment benefit obligations to be presented in the notes. For example, where required by IPSAS 19, an entity discloses information about contingent liabilities arising from post-employment benefit obligations (IPSAS 39 para154).

Contingent assets and liabilities are defined in IPSAS as **possible assets** and obligations arising from past events whose existence will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. A contingent liability may also be a present obligation that arises from a past event, but which is not recognised because an outflow of resources is not probable, or the amount of the obligation cannot be measured with sufficient reliability.

³ Revenue from taxes that are expected to be levied in the future are dependent on future events (= existence of revenue giving rise to tax), and future revenues cannot be recognised in the statement of surplus/deficit.

That additional information provides an insight into an entity's future cash flow needs and the cash flows available to an entity from the amount owed from the plan (in case of a surplus). The proposed disclosures also highlight the risks arising from the pension plans and the matching strategies of the company. Thus, information resulting from the presentation and disclosure requirements in IPSAS 39 is complete and relevant for the users of financial statements.

In addition to the disclosure requirement included in IPSAS 39 para 56 for defined contribution plans, completeness would be enhanced by presenting in addition to the effect on the cash-flows for current period, also the expected cash flows for the future periods.

Prudence

The standard acknowledges that actuarial assumptions are subject to changes and that a significant change in the DBO might arise by introducing the concept of actuarial gains and losses. The following two sources of changes in the present value of the defined benefit obligation result in actuarial gains and losses (IPSAS 39 para 8):

- a) Experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and
- b) The effects of changes in actuarial assumptions.

Actuarial gains and losses are part of the remeasurement component recorded directly in net assets/equity. There is also no recycling of these gains and losses at a future date. Hence, the effects from actuarial gains and losses do not affect surplus or deficit of an entity. It should be noted that the draft EPSAS CF does not acknowledge the existence of "other comprehensive income" (the concept defined under the IFRS CF), and that "other comprehensive income" is not a defined term in IPSAS 1, "Presentation of financial statements". The accounting treatment complies with the QC of prudence since the unrealised sources of measurement uncertainty do not have an impact on the surplus/deficit account of an entity.

IPSAS 39 imposes restrictions to the recognition of a net defined benefit asset that may arise where a defined benefit plan has been overfunded or where actuarial gains have arisen (IPSAS 39 para 66).

When an entity has a surplus in a defined benefit plan, it shall measure the net defined benefit asset at the lower of:

- (a) The surplus in the defined benefit plan; and
- (b) The asset ceiling determined using the discount rate specified in paragraph 85.

An entity recognises a net defined benefit asset in such cases because:

- (a) The entity controls a resource, which is the ability to use the surplus to generate future benefits;
- (b) That control is a result of past events (contributions paid by the entity and service rendered by the employee); and
- (c) Future economic benefits are available to the entity in the form of a reduction in future contributions or a cash refund, either directly to the entity or indirectly to another plan in deficit. The asset ceiling is the present value of those future benefits.

The defined benefit asset recognition criteria are in conformity with the draft ESPAS CF: the defined benefit asset subject to the asset ceiling test creates a resource with service potential or the ability to generate economic benefits.

Based upon the above analysis, application of the requirements of IPSAS 39 provides a prudent reflection of an entity's employee benefit obligations.

Neutrality

Information is neutral if it is free from bias. GPFSSs are not neutral if the information they contain has been selected or presented in a manner designed to influence the making of a decision or judgment in order to achieve a predetermined result or outcome.

The principles included in IPSAS 39 have been tested for many years in the private sector (with IAS 19, the equivalent IFRS standard). Users perceived no negative impact of IAS 19 on the neutrality of the IFRS financial statements. The requirements to apply accounting policies consistently year on year and to disclose such policies in the notes to the accounts reinforce the neutrality QC.

Verifiability

The use of management's estimates and judgment is inherent in the preparation of financial statements. This is particularly true in the area of long-term liabilities, such as pension and other post-employment benefit liabilities for which actuarial assumptions must be used to come up with the measurement. Actuarial assumptions shall be unbiased and mutually compatible (IPSAS 39 para 77). Actuarial assumptions are an entity's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits. Actuarial assumptions are mutually compatible if they reflect the economic relationships between factors such as inflation, rates of salary increase, and discount rates.

The rate used to discount post-employment benefit obligations (both funded and unfunded) shall reflect the time value of money. The currency and term of the financial instrument selected to reflect the time value of money shall be consistent with the currency and estimated term of the post-employment benefit obligations (IPSAS 39 para 85).

Although these assumptions have a material effect on the defined benefit obligation, they are verifiable if they are based on the observable sources of market data. For example, the discount rate reflects only the time value of money but not the actuarial

or investment risk. Furthermore, the discount rate does not reflect the entity-specific credit risk borne by the entity's creditors, nor does it reflect the risk that future experience may differ from actuarial assumptions. These non-observable elements could be difficult to estimate and would not be sufficiently verifiable.

The discount rate that reflects the time value of money is best approximated by reference to the verifiable sources of evidence: market yields at the end of the reporting period on government bonds, high quality corporate bonds, or by another financial instrument. IPSAS 39 leaves some freedom to the entity to determine the discount rate that best achieves the objective of reflecting the time value of money. The basis on which the discount rate has been determined should be disclosed (IPSAS 39 para 141 (d)).

Although the comparability QC might be affected (for example, when different sources of yields are used by different entities within the same jurisdiction), the verifiability QC will be met provided market yields are used and the deep market for the financial instrument exists.

Meeting the IPSAS 39 requirements in terms of the disclosures to be provided helps meet the 'verifiability' QC.

Substance over form

The distinction between defined contribution plans and defined benefit plans is based on the assessment of the substance of the plan and the exposure to actuarial and investment risk (IPSAS 39 para 28):

Under defined contribution plans the entity's legal or constructive obligation is limited to the amount that it agrees to contribute to the fund. Thus, the amount of the post-employment benefits received by the employee is determined by the amount of contributions paid by an entity (and the employee) to a post-employment benefit plan or to an insurance company, together with investment returns arising from the contributions. In consequence, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall, in substance, on the employee.

The characteristics of defined benefit plans include the entity's obligation to pay the promised benefits rather than the obligation of a third party. Also, the actuarial and investment risks associated with the pension promise are borne, in substance, by the entity.

An additional category would be the so-called "hybrid plans" (plans with asset-linked returns, etc.), which may raise some issues in practice. The fact that the actuarial risks or investment risks fall, in substance, on the employee or on the entity is subject to a degree of judgement. It may lead to different entities classifying equivalent plans as defined contribution or defined benefit plans.

IPSAS 39 is expected to result in the benefits for preparers associated with cost savings following the simplification of the accounting model for defined benefits schemes (e.g. elimination of the corridor approach) and the removal of accounting

options that existed in the previous standard. It also allows preparers to align their accounting for pension schemes with the underlying economic substance of those schemes and the economic risks associated with these schemes, thereby resulting in better quality financial reporting.

The standard does not provide specific guidance for post-employment employee benefits (pension plans) promising the higher of the return on an identified item or group of items and a minimum guaranteed return (referred to as an ‘asset-return promise’). One of the main perceived issues with accounting for the plans with an asset return promise is that measurement of the pension obligation and the plan assets does not reflect the economic co-variances between the two following from the terms of the plans. One of the reasons is that the final entitlement benefits are projected with the expected returns on plan assets, while the pension obligation needs to be discounted using a different discount rate. Accordingly, when the expected return on the plan assets is higher than the discount rate, a net pension liability needs to be recognised, even if it is expected that the plan assets will be sufficient to fully settle the pension obligation at retirement.

Given the variety of post-employment benefit plans, the accounting treatment may lead to inconsistencies in application. For example, for certain hybrid plans, in which the benefits paid to employees depend, wholly or partly, on the return on a specified pool of assets, when projecting the benefit on the basis of an assumption of future performance of the specified assets, it may be higher than the discount rate used for the discounting (normally based on government bonds or high quality corporate bonds). Therefore, entities may reflect net liabilities in situations in which no additional contribution is expected to be paid for present or past services.

Understandability

Most of the aspects to the notion of understandability are covered by the discussion about relevance, reliability and comparability.

The main additional issue to consider in assessing whether the information resulting from the application of the standard is understandable, is whether that information is unduly complex for the entities to prepare and the users to interpret. For example, accounting for post-employment benefit obligations is based on actuarial assumptions (a degree of uncertainty increases when the assumptions involve long-term macro-economic parameters), and any changes in assumptions create volatility in the financial statements. In some cases, recognition of considerable long-term obligations under IPSAS 39 approach may lead to a negative net equity reported by public sector entities, due to the fact that the corresponding future income from taxes or contributions are not recognised as assets on the balance sheet.

This may be seen by some as an inappropriate mismatch but however fairly reflects a proper application of the general accrual accounting concepts. In simple terms, it reflects how much a government, in order to meet its present obligations, ‘borrows’ from future generations. The standard does not involve new concepts or notions compared to the equivalent private sector standard IAS 19 that could impair its understandability. If certain aspects linked to the measurement of some benefits can

be complex (i.e. those that involve actuarial computations), those aspects are, from the point of view of the preparers, generally dealt with by a central team of specialists, with the assistance of qualified actuaries. From a users' perspective, appropriate disclosures as required by IPSAS 39, including about the methodology used, assist in the understanding of the numbers that are presented in the primary statements. However, too extensive disclosures could lead to an information overload for users.⁴

The overall objective of the standard is to ensure that financial statements provide users with a clear picture of an entity's commitments resulting from defined benefit plans. IPSAS 39 does not introduce any complexities that would outweigh its benefits and therefore it satisfies the understandability criterion.

Comparability

A key objective of EPSAS is to achieve the necessary level of financial transparency and comparability of financial reporting, between and within EU Member States.

The requirements of IPSAS 39 eliminate the divergent practice in respect of recognising the actuarial gains and losses arising from defined benefit plans through the removal of the options previously contained in IPSAS 25.

IPSAS 39 requires entities to recognise remeasurements in net assets/equity in the period in which they occur; and to recognise a surplus as a net defined benefit asset and a deficit as a net defined benefit liability.

The removal of the options brings consistency in accounting for the actuarial gains and losses included in the remeasurements component, and increases comparability between entities. Therefore, accounting for actuarial gains and losses under IPSAS 39 satisfies the comparability criterion.

IAS 19 requires adoption of a discount rate based on the market yields at the end of the reporting period on high quality corporate bonds. The IPSASB decided that the discount rate should reflect the time value of money, and considered that entities should have the possibility to determine the rate that best achieves that objective.

The IPSASB considered that the time value of money may be best reflected by reference to market yields on government bonds, high quality corporate bonds, or any other financial instrument. The discount rate used is not intended to incorporate the risk associated with defined benefit obligations or entity-specific credit risk. There is an additional disclosure requirement in IPSAS 39 para 141(d) informing users of the basis on which the discount rate has been determined.

This lack of specific guidance on the appropriate discount rate to be used to calculate present value of the defined benefit obligations creates potential for a lack of comparability between governments that may use different sources of discount rates for obligations of similar timing and amount.

⁴ The issue of information overload is addressed in the issue paper 'A principled approach to disclosures'. Judgment is required to assess what disclosures should be given, in compliance with the standard, but also considering materiality and the qualitative characteristics.

Overall, cost-benefit considerations should guide the choice of a particular accounting policy versus another. In addition, different users of financial statements may have different views of what these costs or benefits are.

As mentioned above, the discounting approach set out in IPSAS 39 provides no detailed guidance, which results in lack of clarity and variety of interpretations. When a ‘principle-based’ approach is applied, the calculation always leaves space to judgment by preparers, unless a precise centralised guidance is available or the calculation is performed at a centralised level.

This area of IPSAS 39 may result in lower comparability and may be especially sensitive when the information is used for decision-making purposes.

The standard requires entities to calculate net interest on the net defined benefit liability (asset) using the same discount rate used to measure the defined benefit obligation. This approach results in consistency between entities and removes the subjectivity involved in determining the expected return on assets. However, this approach results in the outcome that deviates from the economic reality for some types of employee benefit plans with asset-linked return (refer to the QC “Substance over form”).

IPSAS 39, as stated in para 136, does not specify how an entity should present service cost and net interest on the net defined benefit liability (asset), and refer instead to IPSAS 1, “Presentation of Financial Statements”. Consequently, and particularly for net interest on a net defined liability, entities would be allowed to present it in different ways, such as operating or financing expenses. This will reduce the level of comparability between different entities applying IPSAS 39.

IPSAS 39 para 60 requires the entity to determine the net defined liability with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the end of the reporting period. Since there is no additional prescriptive guidance, it could lead to an expectations mismatch between the entity and the users of the financial statements regarding the frequency of updates.

The central guidance on the use of discount rates for all government entities within a country or at the level of a certain government could be considered in order to enhance comparability QC of the financial information. Except for this area where more precise and consistent approach could be needed to determine the discount rate, application of the requirements of IPSAS 39, combined with appropriate disclosures provided in the notes about the actuarial assumptions and sensitivity to these assumptions are likely to result in comparable application of the standard across the EU and by entities over time.

The issue around discount rates is further discussed in the EPSAS issue paper on discount rates dates March 2018 and available on Eurostat’s website.

Alignment with other frameworks

ESA 2010

Pension entitlements arising from social security schemes are not included in the core national accounts (ESA 2010.17.81). The diversity of such schemes and employer schemes varies across Member States. Pension entitlements arising from social security schemes are included in the supplementary table for accrued-to-date pension entitlements in social insurance to allow comparison of country data.

The recognition of pension liabilities under ESA 2010 depends on whether the scheme is funded or not. Following ESA 2010 para 17.87 liabilities are indeed only recorded for funded schemes, i.e. when reserves have actually been set aside to meet the entitlements accruing under the scheme:

For other employment-related schemes, pension entitlements of the participants are usually recorded as they build up. Investment income earned on existing pension entitlements is recorded as being distributed to the beneficiaries and reinvested by them in the pension scheme.

In this case, entitlements of the participants are usually recorded as they build up. The measurement guidance for the pension liabilities included in the supplementary tables is founded, in principle, on the same basis as IPSAS 39, e.g. the actuarial calculation is based on the present value of the pension entitlement taking into consideration future salary trends. However, current ESA 2010 also shows details that are not in line with IPSAS 39, e.g. with respect to the discount rate.

No liabilities are recorded in the case of unfunded schemes, as for example a defined benefit pension scheme run by government for its own employees. Given the predominance of PAYG-systems for the financing of pensions in Member States, in many cases no liabilities are recorded under ESA 2010 for pension obligations.

IFRS⁵

IPSAS 39 is drawn primarily from IAS 19 (issued in 2011), including amendments up to December 31, 2015). The main differences between IPSAS 39 and IAS 19 are as follows:

- IPSAS 39 contains additional guidance on public sector bonus plans.
- For discounting post-employment obligations, IAS 19 requires entities to apply a discount rate based on yields on high quality corporate bonds consistent with the currency and estimated term of the post-employment benefit obligations. The requirement in IPSAS 39 is that entities apply a rate that reflects the time value of money. IPSAS 39 also contains a requirement that entities disclose the basis on which the discount rate has been determined.

⁵ Refer to the IPSAS-IFRS Alignment Dashboard regularly updated by the IPSASB available on https://www.ifac.org/system/files/uploads/IPSASB/Agenda%20Item%201.5%20IPSAS%20IFRS%20Alignment%20Dashboard_June%202019.pdf

- IPSAS 39 includes a rebuttable presumption that long-term disability payments are not usually subject to the same degree of uncertainty as the measurement of post-employment benefits. Where this presumption is rebutted, the entity considers whether some or all long-term disability payments should be accounted for in the same way as for post-employment benefits. IAS 19 does not include such a rebuttable presumption.
- IPSAS 39 recognizes remeasurements of the net defined benefit liability (asset) in net assets/equity. IAS 19 recognizes them in other comprehensive income.
- IPSAS 39 uses different terminology, in certain instances, from IAS 19. The most significant examples are the use of the terms “revenue”, “controlling” and “controlled entities”. The equivalent terms in IAS 19 are “income”, “parent” and “subsidiaries”.

EU accounting rules

EAR 12 (December 2017) is dealing with employee benefits and is based on IPSAS 39.

The introduction to EAR 12 summarises the objective of the accounting rules for employee benefits:

“The principle underlying all of the detailed requirements of this rule is that the cost of providing employee benefits should be recognised in the period in which the benefit is earned by the employee, rather than when it is paid or payable.

The principal objectives of post-employment accounting are to measure the cost associated with employees’ benefits and to recognise that cost over the employees’ respective service periods. The periodic costs of post-employment plans have to be assigned properly to the periods in which the related economic benefits are received by the employers incurring these costs”.

EAR 12 has a comment on the use of the discount dates in the EU context: “...the discount rate shall be determined by reference to market yields on government bonds at the reporting date. The currency and period of the government bonds should be the same as the defined benefit obligation”.

European Public Good

Assessing whether IPSAS 39 is conducive to the European public good

The assessment of whether IPSAS 39 would be conducive to the European public good addresses the following items:

- a) Whether the standard will improve financial reporting;
- b) The costs and benefits associated with the standard; and
- c) Whether the standard could have an adverse effect to the European economy, including financial stability and economic growth.

These assessments will allow the EU authorities to draw a conclusion as to whether the standard is likely to be conducive to the European public good.

The analysis revealed no reasons why IPSAS 39 would not be conducive to the European public good:

- Recognition, classification, measurement, presentation and disclosure requirements of IPSAS 39 will provide useful information to the users of the GPFSSs and will improve the overall quality of financial reporting in the public sector. The main criterion in assessing the proposals is whether the accounting information provided about an entity's employee benefit schemes and the uncertainty related to the future outflow of economic benefits that will be required to settle them will be improved when compared to the information provided currently under the local accounting frameworks of the EU member states. Based on the assessment, the requirements of IPSAS 39 satisfy this criterion.
- Pension liabilities in respect of defined benefit schemes rank among the most significant areas in terms of impact on the opening balance sheet when making the transition from a cash-based accounting system to IPSAS. Implementation of the standard should result in a one-off cost and should be relatively cost-neutral on an ongoing basis for preparers. IPSAS 39 is expected to result in benefits for both preparers and users following the simplification of the accounting model for defined benefits schemes (elimination of the corridor approach) and the removal of accounting options that existed in the previous standard.
- Considering its conceptual merits, the standard will bring improved financial reporting when compared to heterogeneous reporting requirements currently applied in the EU. As such, its endorsement is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management stewardship. The analysis has not identified any adverse effect of the standard to the European economy, including financial stability and economic growth, or any other factors that would mean the standard is not conducive to the European public good.

Conclusion

Assessing IPSAS 39 against the criteria formulated in the draft EPSAS framework

The analysis has not revealed major conceptual issues with IPSAS 39 'Employee benefits' and has not identified any inconsistency between IPSAS 39 and the draft EPSAS framework.

Following the screening analysis summarised in the present report, future standard setter could consider following conclusions. The information resulting from the application of IPSAS 39:

- would provide relevant, reliable, complete, prudent, neutral, verifiable, economically substantive, understandable, timely and comparable information needed for making economic decisions and achieving the necessary level of financial transparency and comparability of financial reporting in the European Union;
- would not be contrary to the true and fair view principle; and
- would be conducive to European public good.

However, in order to achieve consistent application of the new standard within the EU context and therefore better address the comparability objective of EPSAS financial statements, additional guidance and improvements in certain areas might be desirable.

- *Selection of an appropriate discount rate.* Application of discounting is the most sensitive issue in relation to post-employment benefit obligations and to a lesser extent other long-term employee benefit obligations. The value of provisions reported in the accounts may be significantly affected by the discount rate used. Providing additional guidance with regard to the discount rate relevant for EU central governments may lead to better consistency in terms of figures reported by central governments. In addition, the impact of negative interest rates on the risk-free rate (as evidenced by government bonds of different maturities issued within the EU) should be addressed. The issue around discount rates is further discussed in the EPSAS issue paper on discount rates dates March 2018 and available on Eurostat's website.
- *Judgment and comparability.* The use of judgment and estimates is inherent in the preparation of financial statements and may to some extent affect the comparability of financial statements. This is particularly true/important in relation to the accounting of post-employment benefit liabilities.

The analysis has not identified any adverse effect of the standard to the European economy, including financial stability and economic growth, or any other factors that would mean the standard is not conducive to the European public good.

The future standard setter could consider the conclusions of this assessment and likely net benefit of using the requirements of IPSAS 39 as a starting point in implementing the equivalent EPSAS, considering the need for additional guidance in certain areas and resolution of the matters identified in the present EPSAS screening report.